

ST 97-20

Tax Type: SALES TAX

Issue: Unreported/Underreported Receipts (Fraud)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE)	Docket No.
OF THE STATE OF ILLINOIS)	Reg. No.
v.)	NTL No.
TAXPAYER)	
)	John E. White,
Taxpayer.)	Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Stephen Lewis, Cooke & Lewis, for TAXPAYER; Alan Osheff, Special Assistant Attorney General, for the Illinois Department of Revenue.

Synopsis:

The Illinois Department of Revenue ("Department") conducted an audit of TAXPAYER ("TAXPAYER" or "taxpayer") for the period December 1989 through and including July 1992. After that audit, the Department issued Notice of Tax Liability number ("NTL no.") XXXXX to assess Retailers' Occupation Tax ("ROT") deficiencies against TAXPAYER. TAXPAYER protested the NTL and requested a hearing.

A hearing was held at the Department's Office of Administrative Hearings. Pursuant to pre-hearing order, the issues to be determined at hearing were: (1) whether the Department correctly calculated the amount of deficiencies; (2) whether the Department's use of a 30% mark-up was reasonable; and (3) whether a fraud penalty was properly assessed. At hearing, the Department presented its auditor's workpapers and other Department books and records, certified copies of TAXPAYER's federal and Illinois corporate income tax returns, and

the testimony of the auditor who conducted the calculation of the NTL and subsequent reaudit of TAXPAYER's business. Taxpayer presented the testimony of its manager, MANAGER ("MANAGER"). I have considered the evidence adduced at hearing, and I am including in this recommendation specific findings of fact and conclusions of law. I recommend the issues be resolved in favor of the Department.

Findings of Fact:

1. TAXPAYER is an Illinois corporation engaged in the business of selling tangible personal property (to wit: liquor, cigarettes, foodstuffs and other merchandise), at retail, at Midlothian, Illinois. Department Exhibit Number ("Ex. No.") 1, Correction of Returns; Department Ex. No. 9, TAXPAYER's 1989-90 Illinois and federal income tax returns.
2. TAXPAYER is registered with the Department for purposes of the Retailers' Occupation Tax Act ("ROTA"), 35 **ILCS** 120/1 *et seq.* (1994). Department Ex. No. 1, Correction of Returns.
3. TAXPAYER conducted business under the assumed names of XXXXX. Department Ex. No. 8, Summary Report, pp. 2-4.
4. TAXPAYER filed ROT returns for all but one month (January 1992) of the audit period. Department Ex. No. 5, 1st audit report, pp. 2-3.¹ No tax delinquency liability was identified on the corrections of returns prepared and introduced by the Department. Department Ex. Nos. 1-3.

¹. When making page references to the Department's exhibits, I am not counting the Certificate of the Director as the first page of the exhibit.

5. TAXPAYER's business was targeted for audit after Department personnel, during a review of sales records obtained from area liquor distributors, noted that TAXPAYER's liquor purchases during the audit period greatly exceeded the amount of taxable gross receipts TAXPAYER reported on ROT returns it filed regarding the same period. Department Ex. No. 8, Summary Report, pp. 14-15; Department Ex. No. 5, 1st audit report, p. 2.
6. TAXPAYER did not make wholesale sales during the audit period (Department Ex. No. 8, Summary Report, p. 5 (TAXPAYER manager MANAGER's statement to Department personnel)), and did not claim to make wholesale sales during the audit period at hearing.
7. After determining TAXPAYER was not making wholesale sales (Department Ex. No. 8, Summary Report, p. 5), and since TAXPAYER's wholesale purchases of alcoholic beverages greatly exceeded the amount of gross receipts TAXPAYER reported it received from all of its high rate sales during the same period, the Department determined that TAXPAYER was underreporting the true amount of its taxable gross receipts. Department Ex. No. 8, Summary Report, pp. 14-15.
8. Department personnel prepared a schedule in which certain of TAXPAYER's wholesale liquor, soft-drink and cigarette purchases during the audit period were compared with the amount of taxable gross receipts TAXPAYER reported on the ROT returns it filed during the applicable period. Department Ex. No. 8, Summary Report, pp. 14-15; Department Ex. No. 5, 1st audit report, p. 2.
9. At hearing, TAXPAYER did not challenge the accuracy of the books and records the Department used to calculate its wholesale

- purchases the Department used to measure TAXPAYER's wholesale purchases of beer and liquor during the audit period, nor did TAXPAYER ever argue that it did not underreport the amount of taxable gross receipts on returns filed during the audit period.
10. TAXPAYER's inventory stayed relatively constant during the audit period. Tr. p. 57 (TAXPAYER's manager MANAGER).
 11. When preparing the schedules designed to calculate TAXPAYER's actual taxable gross receipts during the audit period, the auditor added a 30% mark-up to TAXPAYER's purchase price for the wholesale goods it later sold at retail. Department Ex. No. 5, p. 2.
 12. The Department auditor decided to use a 30% mark-up because TAXPAYER did not have books and records from which TAXPAYER's actual mark-up could be determined (see Department Ex. No. 5, pp. 2-3), because TAXPAYER's federal returns indicated a mark-up higher than 30%, and because a retail industry reference book commonly used by Department auditors indicated that similar stores, on average, use a mark-up of approximately 33%. Tr. pp. 31-34 (Burgett, describing Department Ex. No. 10, as the Robert Morris associates book).
 13. On its 1989 federal income tax returns, TAXPAYER reported that its cost of goods sold (purchases minus remaining inventory) was \$101,960.00, its gross receipts from sales were \$142,737.00, and its gross profit (i.e., gross receipts from sales minus cost of goods sold) was \$40,777.00. Department Ex. No. 7, pp. 4-5 (1989 form 1120). Based on those figures, TAXPAYER's mark-up during

1989 was approximately 40%. Tr. pp. 29-30 (Burgett) (40,777 - 101,960 ~ .399931 or approximately 40%).

14. On its 1990 federal income tax returns, TAXPAYER reported that its cost of goods sold was \$97,122.00, its gross receipts from sales were \$137,665.00, and its gross profit was \$40,543.00. Department Ex. No. 7, pp. 17-18 (1990 form 1120). Based on those figures, TAXPAYER's mark-up was approximately 42% in 1990. Tr. p. 30 (Burgett) (40,543 - 97,122 ~ .417444 or approximately 42%).
15. TAXPAYER's manager admitted he applied a mark-up on the tangible personal property TAXPAYER sold at retail (Tr. p. 53 (MANAGER)), although he testified that he used an average mark-up of between 5-10% for cases of beer, between 10-17% for kegs of beer, and 20% for liquor. Tr. p. 54 (MANAGER). MANAGER said that 80% of TAXPAYER's business was sales of beer. Tr. p. 54 (MANAGER). TAXPAYER introduced no documentary evidence to corroborate MANAGER's testimony regarding the mark-up TAXPAYER used.
16. MANAGER, TAXPAYER's manager, provided the accountants who prepared TAXPAYER's ROT returns with books and records used to prepare TAXPAYER's ROT and other tax returns. Department Ex. No. 8, Summary Report, pp. 12-13; Tr. p. 57 (MANAGER).
17. After TAXPAYER protested the NTL the Department issued, TAXPAYER asked the Department to conduct a readit to review books and records not previously viewed by the Department's auditor. See Department Ex. Nos. 4, 7; Order dated 1/9/96 (assigning matter for a readit). After reviewing the documents tendered by TAXPAYER during readit, the Department's auditor determined

that TAXPAYER's taxable gross receipts were greater than those on which the ROT assessed was measured. Tr. pp. 35-36, 51-52 (Burgett). However, because the auditor believed he was unable to increase the amount of an NTL already issued (*id.*), he never presented to counsel for taxpayer any schedules he testified he prepared during the reaudit. Tr. p. 52 (Burgett).

18. After the auditor testified that the books and records he reviewed during reaudit indicated TAXPAYER's taxable receipts were greater than those used to calculate the amount of tax identified on the NTL, counsel for the Department did not seek to update or revise the original corrections of TAXPAYER's returns (introduced as Department Ex. Nos. 1-3), and he argued that "the NTL was correct as originally found in the audit". Tr. p. 61 (closing argument).

Conclusions of Law:

The issues in this matter are: (1) whether the Department correctly calculated the amount of deficiencies; (2) whether the Department's use of a 30% mark-up was reasonable; and (3) whether a fraud penalty was properly assessed. I will address each issue in reverse order.

This is not a case where TAXPAYER argues that it underreported the total amount of its taxable gross receipts due to some mistake. TAXPAYER, in fact, has never argued the Department erred when it determined TAXPAYER underreported taxable gross receipts on the returns it filed regarding the audit period. See Pre-Hearing Order (identifying issues detailed *infra*, p. 1). Conceding that underlying

fact, TAXPAYER instead argues the Department did a poor job of calculating the true amount of its taxable gross receipts. TAXPAYER's concession of that issue alone is sufficient to conclude the fraud penalty was appropriate. Here, however, there is clear and convincing evidence of TAXPAYER's intentional underreporting of taxable gross receipts.

The Department determined TAXPAYER underreported its taxable gross receipts when, during a review of area vendors' records covering the audit period, it was discovered TAXPAYER made wholesale purchases of beer and liquor which exceeded its reported taxable gross receipts by a factor of over 3 to 1. Department Ex. No. 8, pp. 14-15. That figure is consistent with a Department investigator's report that TAXPAYER's reported high rate taxable gross receipts tripled after the Department made TAXPAYER aware of its investigation. Department Ex. No. 8, p. 16. At hearing, taxpayer never disputed the accuracy of the vendors' records the Department used as the basis for calculating TAXPAYER's gross receipts during the audit period. See Tr. p. 56 (MANAGER). The level of underreporting evidenced by those records was so great the auditor repeatedly sought to confirm taxpayer was not purchasing at wholesale for another business. Department Ex. No. 5, p. 3; Department Ex. No. 7, p. 7.

The schedules Department personnel prepared in this case, coupled by TAXPAYER's failure to even argue that its purchases were less than what were reflected on its vendor's records, lead inescapably to the conclusion that TAXPAYER regularly and purposefully underreported the true amount of taxable gross receipts

on returns it filed regarding the audit period. Vitale v. Department of Revenue, 118 Ill. App. 3d 210, 213 (3d Dist. 1983). Therefore, the fraud penalty was properly assessed.

Regarding the second issue, counsel for TAXPAYER argues that the Department should not have used a 30% percent mark-up when calculating TAXPAYER's taxable gross receipts. Instead, counsel asserts, the Department should have used a mark-up of between 5-10% for beer and 10-20% for liquor. Tr. p. 64 (argument of counsel). No documentary evidence of record, however, supports TAXPAYER's claim that it used a mark-up less than the one applied by the Department's auditor. While counsel for the taxpayer is correct when he argues the evidence establishing the Department's *prima facie* case is a rebuttable presumption (Tr. pp. 63-64), testimony alone can have no effect against such a presumption if the testimony is not corroborated or identified with reference to taxpayer's books and records. *E.g.*, Copilevitz v. Department of Revenue, 41 Ill. 2d 154, 157 (1968); Soho Club, Inc. v. Department of Revenue, 269 Ill. App. 3d 220, 229 (1st Dist. 1995); A.R. Barnes v. Department of Revenue, 173 Ill. App. 3d 826, 833-34 (1st Dist. 1988).

The records TAXPAYER made available for reaudit were reviewed by the auditor, summarized in his reaudit comments, and determined to be insufficient to identify TAXPAYER's actual selling price for the specific tangible personal property the Department used to measure TAXPAYER's taxable gross receipts. For example, the auditor made several entries in his reaudit comments to document that the records TAXPAYER provided regarding various months in the audit did not include cash register tapes from which taxpayer's actual selling

price (and thereby, the mark-up) could be identified for TAXPAYER's sale of specific beers or liquors. Department Ex. No. 7, pp. 2-7 (2d reaudit report); see also 86 Ill. Admin. Code § 130.805(a) (1988) (cash register tapes included within the list of records required to be maintained by a retailer). MANAGER admitted he marked-up the tangible personal property TAXPAYER sold, but TAXPAYER introduced no documentary or other credible evidence closely identified with its books and records to corroborate its manager's testimony.²

Not only did TAXPAYER fail to corroborate MANAGER's testimony that TAXPAYER used a mark-up of less than 30% on beer and liquor, the books and records it did produce for reaudit show that taxpayer used a mark-up greater than 30% on other items of tangible personal property it sold at retail. For the only monthly period regarding which TAXPAYER actually tendered cash register tapes (11/91), the auditor was able to determine TAXPAYER used a 41% mark-up for cigarettes. Department Ex. No. 7, pp. 5-6 (2d reaudit report). TAXPAYER's federal income tax returns, moreover, show taxpayer used a mark-up of almost 40% of its cost of goods sold for 1989, and a mark-up of almost 42% in 1990. Department Ex. No. 9, pp. 4-5 (1989 form 1120), 17-18 (1990 form 1120). TAXPAYER's own books and records completely contradict its argument that the Department used an unreasonably large mark-up to calculate TAXPAYER taxable gross

². TAXPAYER's assertion that it was unable to produce books and records for review or at hearing because they were seized by a governmental agency cannot help it here. MANAGER testified the records seized were returned to the store prior to hearing. Tr. p. 59 (MANAGER); see also Masini v. Department of Revenue, 60 Ill. App. 3d 11, 15 (1st Dist. 1978) (records must be introduced at hearing to rebut the Department's *prima facie* case).

receipts during the audit period. Therefore, I conclude the 30% mark-up was reasonable.

The final issue is whether the Department correctly calculated the amount of TAXPAYER's deficiencies. The Department introduced its corrections of TAXPAYER's returns into evidence under the certificate of the Director. Department Ex. Nos. 1-3. The Department's corrections of a taxpayer's returns constitutes *prima facie* proof of the correctness of the amount of tax due. 35 ILCS 120/4. The statutory presumption of correctness which attaches to the Department's correction of returns is only overcome once a taxpayer introduces some credible evidence identified with its books and records to show the Department's corrections were in error. Copilevitz v. Department of Revenue, 41 Ill. 2d 154, 157, 242 N.E.2d 205, 207 (1968); DuPage Liquor Store, Inc. v. McKibbin, 383 Ill. 276, 279, 48 N.E.2d 926, 927 (1943). Here, the only evidence TAXPAYER offered was the testimony of its manager, who described generally the mark-ups TAXPAYER used when selling beer and liquor. TAXPAYER introduced no books and records, and no credible evidence identified therewith, to corroborate the substance of MANAGER's testimony, or to otherwise show the tax due was less than the amount identified in the Department's corrections of returns.

It is important to recall that TAXPAYER did not have books and records necessary to identify the total amount of gross receipts it realized from selling tangible personal property at retail during the audit period. 35 ILCS 120/7; 86 Ill. Admin. Code § 130.805. Under such circumstances, vendors' records constituted the best information available to the Department. The Department's use of such records to

correct a taxpayer's filed returns is a practice long sanctioned by Illinois courts. See, e.g., DuPage Liquor Store, Inc. v. McKibbin, 383 Ill. at 280, 48 N.E.2d at 927. The Department prepared the corrections of TAXPAYER's returns by: (1) adding together TAXPAYER's known wholesale purchases of liquor, soda and cigarettes; (2) multiplying that total by a 30% mark-up to calculate the amount of taxable gross receipts TAXPAYER would have realized from its sales of such property; and finally, (3) multiplying TAXPAYER's taxable gross receipts (as calculated) by the statutory ROT rate. Department Ex. No. 4, pp. 2-3.

If anything, the evidence suggests the Department may have underestimated TAXPAYER's tax deficiencies by not using information -- contained in books and records TAXPAYER tendered for the first time during reaudit -- to revise its original corrections of TAXPAYER's returns. In his reaudit reports, and during his testimony at hearing, the Department's auditor stated TAXPAYER submitted for reaudit books and records not previously seen by the Department, which records documented TAXPAYER's wholesale purchases of tangible personal property other than the property the Department used in its original calculation of TAXPAYER's taxable gross receipts. Department Ex. No. 7, pp. 7-8; Tr. p. 35 (Burgett). The auditor noted in his reaudit comments that his original calculation of TAXPAYER's taxable gross receipts would have been greater had such books and records been available to him when he prepared the corrections of TAXPAYER's returns. Department Ex. No. 7, pp. 7-8.

At hearing, the auditor testified that he prepared schedules during the reaudit to calculate TAXPAYER's total taxable gross

receipts as shown by the additional information tendered during the reaudits. Tr. p. 52 (Burgett). The auditor never sought to revise the corrections of returns prepared following the original audit, however, because he believed he was unable to increase the amount of an NTL already issued. *Id.* pp. 35-36, 51-52.³ Had the Department sought to revise its corrections of returns in order to identify the better estimate of TAXPAYER's taxable gross receipts during the audit period, TAXPAYER would have been hard-pressed to justify an objection. Rentra Liquor Dealers, Inc. v. Department of Revenue, 9 Ill. App. 3d 1063, 1071 (1st Dist. 1973). TAXPAYER wanted the reaudit conducted, and any additional (or reduced) amount of tax due would have been premised on the Department's review of TAXPAYER's own books and records.

³. The precise misapprehension of law held by the auditor was dismissed by the Illinois appellate court over twenty years ago in Rentra Liquor Dealers, Inc. v. Department of Revenue, a case in which the court quoted approvingly the trial court's recognition that:

. . . the Retailers' Occupation Tax Act in no way prohibits the Department from determining the true and actual amount of tax liability found from the evidence to exist -- unrestricted by its initial determination -- but to the contrary, that Act contemplates that such be done.

Rentra v. Department of Revenue, 9 Ill. App. 3d 1063, 1071 (1st Dist. 1973).

The Department's treatment of a reaudit as a one-way street (i.e., one leading down, but never up) is especially puzzling here, in a case where fraud has been asserted and shown by the Department, never denied by the taxpayer, and where the NTL at issue has not yet been finalized. See Austin Liquor Mart, Inc. v. Department of Revenue, 51 Ill. 2d 1, 4-6, 280 N.E.2d 437, 439-40 (1972) (where fraud is alleged, Department can seek to reexamine amount of retailers' occupation tax due, even for periods during which prior tax assessment was finalized); see also 35 ILCS 5/906 (where fraud is alleged, Department may issue income tax notice of deficiency, even for periods during which a previously issued NOD was finalized).

I conclude TAXPAYER did not rebut the Department's *prima facie* case. The evidence shows the correct amount of tax due is at least the amount identified on the corrections of returns, and on the NTL. I recommend the Director finalize Notice of Tax Liability no. XXXXX as issued, with interest to accrue pursuant to statute.

Date

Administrative Law Judge